

The accounting equation

1. What is assets and liability?

Assets: An asset is an economic resource controlled by the entity as a result of past events from which future economic benefits are expected to flow. Anything tangible or intangible that is capable of being owned or controlled to produce value and that is held to have positive economic value is considered an asset. Simply stated, assets represent ownership of value that can be converted into cash (although cash itself is also considered an asset). The balance sheet of a firm records the monetary value of the assets owned by the firm. It is money and other valuables belonging to an individual or business. Two major asset classes are tangible assets and intangible assets. Tangible assets contain various subclasses, including current assets and fixed assets. Current assets include inventory, while fixed assets include such items as buildings and equipment. Intangible assets are nonphysical resources and rights that have a value to the firm because they give the firm some kind of advantage in the market place. Examples of intangible assets are goodwill, copyrights, trademarks, patents and computer programs, and financial assets, including such items as accounts receivable, bonds and stocks.

Liability is defined as a present obligation of an entity arising from *past* transactions or events, the settlement of which may result in the transfer or use of assets, provision of services or other yielding of economic benefits in the future. A liability is defined by the following characteristics:

- Any type of borrowing from persons or banks for improving a business or personal income that is payable during short or long time;
- A duty or responsibility to others that entails settlement by future transfer or use of assets, provision of services, or other transaction yielding an economic benefit, at a specified or determinable date, on occurrence of a specified event, or on demand;
- A duty or responsibility that obligates the entity to another, leaving it little or no discretion to avoid settlement; and,
- A transaction or event obligating the entity that has already occurred.

2. The business is a separate entity explains?

In accounting, a business or an organization and its owners are treated as two separately identifiable parties. This concept is called business **entity concept**. In accounting, the separate entity concept treats a business as distinct and separate from its owners. The business stands apart from other organizations as a separate economic unit. It is necessary to record the business's transactions separately, to distinguish them from the owners' personal transactions. This helps to give correct determination of true financial condition of the business. This concept can be extended to accounting separately for the various divisions of a business in order to ascertain the financial results for each division. The idea here is that the financial transactions of one individual or a group of individuals must be kept separate from any unrelated financial transactions of those same individuals or group.

3. What is accounting equation?

The three basic elements of accounting are assets, liabilities and owners' equity (capital). The assets represent the things of value that a business owns. The liabilities are the claims of the creditors against those assets. The owner's equity (capital) is the claim of the owner against those assets. Whatever is not claimed

by the creditors belongs to the owner. As a result, the total claims against the assets are always equal to the total assets. This equality between the assets and the liabilities and the owner's equity is expressed by the "**accounting equation**".

$$\text{Assets} = \text{Liabilities} + \text{Owner's Equity}$$

The two sides of the accounting equation must always be equal because the rights, to all the assets of a business are owned by someone. The creditors have a claim against the assets of a business until the liabilities have been paid. The owner has a claim against the remaining assets of the business. If no liabilities exist, then the owners' equity will equal to the total assets. A clear understanding of the accounting equation is essential, because most of accounting systems based on it. The equation actually identifies the claims (or rights) against the assets held by a business. The two sides represent different versions of the same thing. The left side of the equation, assets, consists of the "resources" (properties) held by the business; the right side of the equation, equities (creditor's claim and owner's claim against the assets) consists of the "sources".

Resources: what they are = Sources: who supplied them

Assets = Claims against assets

4. What are Trade receivable and Trade Payables?

Trade receivables are due from customers for merchandise sold or services performed in the ordinary course of business. Trade receivables may either be accounts receivable or notes receivable. Nontrade receivables come into being from other types of transactions and may be written promises to pay monies or deliver services. Examples are advances to employees, claims against other entities (i.e., tax refunds, insurance receipts), deposits, and financial receivables (i.e., interest receivable, dividend receivable).

Trade payables are obligations to pay for goods or services that have been acquired in the ordinary course of business from suppliers. These liabilities are classified as current liabilities if payment is due within one year or less (or in the normal operating cycle of the business if longer). If not, they are presented as non-current liabilities.

5. What is accrual Concept?

The meaning of accrual is something that becomes due especially an amount of money that is yet to be paid or received at the end of the accounting period. It means that revenues are recognized when they become receivable. Though cash is received or not received and the expenses are recognized when they become payable though cash is paid or not paid. Both transactions will be recorded in the accounting period to which they relate. Therefore, the accrual concept makes a distinction between the accrual receipt of cash and the right to receive cash as regards revenue and actual payment of cash and obligation to pay cash as regards expenses. The accrual concept under accounting assumes that revenue is realized at the time of sale of goods or services irrespective of the fact when the cash is received. For example, a firm sells goods for Rs 55000 on 25th March 2014 and the payment is not received until 10th April 2014, the amount is due and payable to the firm on the date of sale i.e. 25th March 2014. It must be included in the revenue for

the year ending 31st March 2014. Similarly, expenses are recognized at the time services provided, irrespective of the fact when actual payment for these services is made. For example, if the firm received goods costing Rs.20000 on 29th March 2014 but the payment is made on 2nd April 2014 the accrual concept requires that expenses must be recorded for the year ending 31st March 2014 although no payment has been made until 31st March 2014 through the service has been received and the person to whom the payment should have been made is shown as creditor. In brief, accrual concept requires that revenue is recognized when realized and expenses are recognized when they become due and payable without regard to the time of cash receipt or cash payment.

Significance

It helps in knowing actual expenses and actual income during a particular time period. It helps in calculating the net profit of the business.

6. What are current & Noncurrent liabilities and assets?

Current liabilities are the obligations that are expected to be paid off in the operating cycle or one year of the business. It is most likely that current liabilities require cash outflows for settlement. The accounts that are included in current liabilities are accounts payable, notes payable, accrued expenses etc. These are short term obligations.

Long term liabilities or noncurrent liabilities are obligations that are not expected to pay off in the near future, they are to be paid off after one year. Examples of noncurrent liabilities are bond and loan repayment etc.

Current assets are those assets that could be sold, lent or leased to produce some sort of an income or generate some value for the business in the near foreseeable future. Usually, current assets can be liquidated within one fiscal year or within one operating cycle for the company.

Non-current assets (also called fixed assets), are assets which tend to remain in the business for a longer period of time. These assets are not involved in the day-to-day operations of the business, and cannot be used to meet short-term, operational obligations of the business. Fixed assets include immovable property, plant/production units, equipment's and in some modern business definitions, also human resources. According to accounting principles followed worldwide, non-current assets generally include land, buildings, motor vehicles, furniture and office property. Fixed assets are assets whose present value can favorably be accrued to the business at some point of time and thus, indirectly generating an income. It might be noted that unlike current assets, these assets can't be sold to the general consumer base, or liquidated instantly to cash. In addition to this, fixed assets are liable to undergo depreciation in most cases. Moreover, in many countries they are subject to tax rebates and certain percentage-exemptions as well.

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